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LEGAL RULING 2003-2

SUBJECT: Application of Profit Split Method to Water's-Edge Taxpayers with Possessions Corporation Affiliates

PURPOSE

Advice has been requested as to whether California has conformed to the federal "profit split" method of allocating income and deductions of a possessions corporation under Internal Revenue Code (hereinafter "IRC") section 936(h)(5)(C)(ii)(I), thereby allowing that method to be used by water's-edge taxpayers.

ISSUE

May a water's-edge taxpayer use the federal profit split method to allocate income and deductions of its possessions corporation affiliate?

FACTS

P, a United States incorporated corporation, has substantial intercompany transactions during the year with its unitary domestic subsidiary, S, which conducts manufacturing operations in Puerto Rico. S has made an election under IRC section 936 for federal tax purposes, and S has elected to use the profit split method of income allocation provided in IRC section 936(h)(5)(C)(ii)(I). For California franchise tax purposes, P has made a water's-edge election and properly excluded S from the water's-edge group.

LAW AND ANALYSIS

Revenue and Taxation (hereinafter "Rev. and Tax.") Code section 25110 prescribes the entities to be included in a water's-edge combined report. While domestic (United States) incorporated entities are generally included in the combined report, Rev. and Tax. Code section 25110, subdivision (a)(3), specifically excludes domestic corporations making an election pursuant to IRC sections 931 to 936, inclusive (so-called "possessions corporations"). Because possessions corporations are excluded from the water's-edge combined report, their transactions with affiliates must be accounted for on an arm's-length basis.

Rev. and Tax. Code section 25114 generally requires the Franchise Tax Board to examine the returns of water's-edge taxpayers and to make adjustments to prevent evasion of tax or to clearly reflect income, and provides in subdivision (b)(1), in pertinent part, that:

In the case of any transfer (or license) of intangible property (within the meaning of Section 936(h)(3)(B) of the Internal Revenue Code), the income with respect to that transfer or license shall be commensurate with the income attributable to the intangible property.

IRC section 936(h)(3)(B) provides:

Intangible property. The term "intangible property" means any—

- (i) patent, invention, formula, process, design, pattern, or know-how;
- (ii) copyright, literary, musical, or artistic composition;
- (iii) trademark, trade name, or brand name;
- (iv) franchise, license, or contract;
- (v) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or
- (vi) any similar item,

which has substantial value independent of the services of any individual.

Rev. and Tax. Code section 25114, subdivision (b)(2), further provides, in pertinent part, that:

In making distributions, apportionments, and allocations under this section, the Franchise Tax Board shall generally follow the rules, regulations, and procedures of the Internal Revenue Service in making audits under Section 482 of the Internal Revenue Code.

Thus, under the circumstances relevant herein, the Franchise Tax Board is specifically directed under the water's-edge rules to use IRC section 482 when making income adjustments among affiliates within and without the water's-edge group.

The question then arises as to whether, although the use of IRC section 482 and the regulations thereunder for California water's-edge purposes is generally prescribed, the profit split method is still available for use by taxpayers electing under IRC section 936(h)(5)(C)(ii)(I). This issue arises because Treasury Regulation section 1.482-1(h)(3)(ii) specifically provides that:

The provisions relating to cost sharing under section 482 do not apply to payments made pursuant to an election under 936(h)(5)(C)(i)(I). Similarly, a profit split payment, for the purposes of section 936(h)(5)(C)(ii)(I), is calculated using the provisions of section 936 and the regulations thereunder, not section 482 and the regulations thereunder.

Thus, the federal regulation prescribes that for those taxpayers electing under IRC section 936 and electing further to employ the profit split method of allocating income permitted

under that section, the provisions of IRC section 482 will not be applicable for federal purposes.

However, for California purposes, no election under a California counterpart of IRC section 936 is possible, for none exists. IRC section 936 provides for a credit against the tax arising from various classes of possessions corporation income to those taxpayers electing under that section. California not only has no counterpart to IRC section 936, but Rev. and Tax. Code section 23051.5, subdivision (b)(8), specifically states that when applying the IRC for purposes of the Corporation Tax Law, a reference to federal tax credits and carryovers of federal tax credits shall not be applicable for California purposes, unless otherwise specifically provided.

Conformity to federal law may only be accomplished by affirmative legislative action, *Appeal of Rapid American Corporation*, 97-SBE-019-A (May 8, 1997), and no specific provision in the Rev. and Tax. Code incorporates the credit allowed under IRC section 936 into the California franchise tax law. The reference to IRC section 936(h)(3)(B) in Rev. and Tax. Code section 25114, subdivision (b)(1), is merely to a definitional subparagraph that has no function other than to describe and enumerate certain types of intangible property. Because the provisions of Rev. and Tax. Code section 23051.5, subdivision (b)(8), preclude the incorporation of any part of IRC section 936 into the Rev. and Tax. Code, other than as specifically provided (in this case, IRC section 936(h)(B)(3) is referred to merely for the limited purpose of defining intangible property), the profit split method of IRC section 936(h)(5)(C)(ii)(I) does not apply for California franchise tax purposes. Rather, income and expenses must be allocated among members of the water's-edge group and affiliated possessions corporations pursuant to IRC section 482 and the regulations thereunder, as specified in Rev. and Tax. Code section 25114, subdivision (b).

HOLDING

Because the provisions of IRC section 936 do not apply for California purposes, the profit split method allowed under IRC section 936(h)(5)(C)(ii)(I) is not applicable for California purposes. Income and deductions should be allocated between P and S according to IRC section 482 and the regulations thereunder, without regard to a federal profit split election.

DRAFTING INFORMATION

The principal author of this ruling is Claudia K. Land of the Franchise Tax Board, Legal Branch. For further information regarding this ruling, contact Ms. Land at the Franchise Tax Board, 1212 Avenue of the Americas, 4th Floor, New York, New York 10036.